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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1961.

No. 415.

HAROLD M. and SECRIE EKBERG,
Petitioners,

vs.

UNITED STATES OF AMERICA,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT.

HUBBARD FREMONT FELLOWS,
P. O. Box 66,
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THOMAS H. FOYE,
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and
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IN THE

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No. .

HAROLD M. and SECRIE EKBERG,
Petitioners,

vs.

UNITED STATES OF AMERICA,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT.

Come now Harold M. Ekberg and Secrie Ekberg, petitioners, by their attorneys, Hubbard Fremont Fellows, Thomas H. Foye and Donn Bennett, and respectfully petition this Court for a writ of certiorari to review the judgment of the United States Court of Appeals for the Eighth Circuit in the case of *United States* v. *Harold M. and Secrie Ekberg*, No. 16,539 Civil; and respectfully represent:

OPINIONS BELOW.

No formal opinion was rendered by the United States District Court for the District of South Dakota. Its findings of fact and conclusions of law, which are not officially reported, are found at pages 22 through 26 of the transcript of record. The opinion of the United States Court of Appeals for the Eighth Circuit is not yet officially reported. A copy of that opinion is attached hereto as Appendix A.

GROUNDS FOR JURISDICTION.

The grounds upon which the jurisdiction of the Supreme Court of the United States is invoked are as follows:

A. The date of the judgment sought to be reviewed is June 21, 1961. It, and the opinion in support thereof, were entered on that day.

B. No petition for rehearing was filed.

C. It is believed that 28 U.S.C., 1958 Ed., Section 1254, confers upon the Supreme Court of the United States jurisdiction to review the judgment in question by writ of certiorari.

QUESTIONS PRESENTED FOR REVIEW.

1. Whether the Commissioner of Internal Revenue can, by regulation compelling accrual basis ranchers using the unit-livestock-price method of valuing inventory to include raised breeding livestock in inventory at their unit value, reduce the amount of capital gain to which they would otherwise be entitled upon the sale of such livestock.

2. If a regulation thus limiting the amount of such ranchers' income which qualified for capital gain treatment is an invalid exercise of administrative power, whether correction of the error occasioned by compliance with the regulation, through removal of the raised breeding livestock from inventory and amortization of the erroneously accrued unit price basis to zero constitutes a change of accounting method requiring the Commissioner's consent.

STATUTES AND REGULATIONS INVOLVED.

Internal Revenue Code of 1939:

Section 117(j), 26 U.S.C., 1958 Ed., Sec. 117 (j).

Internal Revenue Code of 1954:

Section 446 (e), 26 U.S.C., 1958 Ed., Sec. 446 (e).
Section 1231 (b, 26 US.C., 1958 Ed., Sec. 1231 (b).

Treasury Regulations 111:

Section 29.22 (c)-6.

Treasury Regulations 118:

Section 39.22 (c)-6(f).

Treasury Regulations Promulgated under the Internal Revenue Code of 1954:

Section 1.446-1 (a).
Section 1.446-1 (e).
Section 1.471-6 (d).
Section 1.471-6 (f).
Section 1.471-6 (g).

The above cited statutes and regulations are set out in full in Appendix B attached hereto.

STATEMENT OF THE CASE.

This is a suit for refund of income taxes and interest allegedly overpaid by the petitioner-taxpayers for the years 1954, 1955 and 1956. Mrs. Ekberg is involved herein only because joint returns were filed for the years in issue. Therefore, reference to the taxpayer is intended to apply to both petitioners.

The taxpayer has been engaged in the business of raising pure-bred Aberdeen Angus cattle in Harding County, South Dakota, since 1947. (R. pp. 20, 27-29). A breeding herd of cattle is constantly maintained, to which is added only heifers and cows raised by the taxpayer. All heifer calves born in the herd are held for breeding purposes until otherwise designated. (R. p. 20).

During the years in issue the taxpayer kept books and filed income tax returns using the accrual (inventory) method of accounting. (R. p. 19). Since 1948 the taxpayer has used the unit-livestock-price method of valuing inventories, which include raised breeding livestock. A unit price of $70 per head has always been assigned to raised livestock, and, pursuant to Internal Revenue Service regulations, all raised breeding livestock have been included in inventory at that value in the year of birth. (R. pp. 20, 29).

The inclusion of these animals in inventory resulted in increasing the taxpayer's ordinary income in the amount of the unit value per head in the year in which they were so included. If he was subject to tax in that year, the increased ordinary income obviously added to the ordinary income tax to be paid by him in that year. On the other hand, it reduced the amount of income from the sale of the animals that was entitled to capital gain treatment, because

the taxpayer was required to deduct the accrued inventory value from the sale price in order to compute the amount of the profit to which the capital gain rate would apply. (R. pp. 38-39).

Having long been under the impression that it was improper to include breeding livestock in an inventory held for sale, the taxpayer in 1951 and 1952, attempted to remove such stock from inventory in one year, by deducting its entire value in that year and thus arriving at a zero basis. This attempt was disallowed by Government agents. (R. pp. 42-43).

In the years in question the taxpayer, proceeding on the same theory as before, attempted to correct the erroneous inclusion in inventory of raised breeding livestock by placing them on what was denominated as a depreciation schedule[1] and seeking to deduct, over the remaining useful lives of the animals, the unit value previously accrued for inventory purposes. This was an attempt to recover the ordinary income tax paid on the value of these animals at the time they were included in inventory, by gradually reducing the inventory value to zero through annual charges against ordinary income, so that upon sale at the end of their useful lives as breeders, he would be entitled to capital gain treatment of the entire sales price, which would give him a capital gain advantage equal to that enjoyed by breeding herd owners who filed their income tax returns in accordance with the cash method of accounting. (R. pp. 44-45). No purchased breeding stock was removed from inventory in the years in question. (R. p. 21).

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1. As the Court of Appeals recognized, p. 5, Appendix A, this was a misnomer, because the "depreciation schedule" was in fact only an amortization of the erroneously accrued inventory value. Accordingly, this case does not involve the usual income tax concept of depreciation.

If it is assumed to be error to include the value of raised breeding livestock in inventory, as required by Treasury Regulations, the method chosen by this taxpayer to correct that error is the most equitable, as far as the government is concerned, of the several methods available, because it spreads the deductions over several years instead of claiming the entire deduction in one year, which is the result reached by the other methods. (R. pp. 39-40).

The taxpayer made no other alteration in the accrual method of reporting income for tax purposes. (R. pp. 48-50).

In 1957 the taxpayer submitted to the Commissioner of Internal Revenue a request for permission to change from the accrual method to the cash receipts and disbursements method of computing income for tax purposes. This request was not considered, because it was then the policy of the Internal Revenue Service not to consider such requests until final regulations had been issued under the Internal Revenue Code of 1954. (R. pp. 50-54). Similarly, the evidence is uncontradicted that the Commissioner would have given no consideration to a request for permission to change accounting methods submitted during any of the years in issue. (R. pp. 40-41, 45).

The deductions claimed for amortization of the accrued inventory value of the raised breeding stock in question were disallowed by the Commissioner of Internal Revenue. The taxpayer paid the resulting deficiencies, filed claims for refund thereof and, upon disallowance of the claims, timely instituted this suit to recover the deficiencies and interest. (R. pp. 19-20).

The District Court, in holding for the taxpayer, found as a fact that he had changed the accrual method of reporting taxable income, but only to the extent of transfer-

ring breeding stock from inventory to the depreciation schedule, and in the process made no changes in the inventory valuations given to such livestock. It also found as a fact that the change was made under a claim that Congress intended farmers reporting livestock sales under the accrual method to have tax benefits equal to those available to farmers reporting such sales on a cash basis, and accordingly, found that the Commissioner's consent to the change was not required, the regulations governing such consent being inapplicable. (R. pp. 22-23).

The court concluded as a matter of law that the taxpayer had the right to transfer the raised breeding stock from inventory to a depreciation schedule and to depreciate to zero the cost basis of each animal in the herd over its remaining useful life; that such a transfer did not constitute a change of accounting methods requiring the Commissioner's consent; that therefore the statute and regulations prohibiting change of accounting methods without the Commissioner's consent were inapplicable; and that the taxpayer, by use of his chosen method, was achieving capital gain treatment approximating, though not equalling, that accorded breeding stock owners who use the cash receipts and disbursements method of reporting income for tax purposes. (R. pp. 24-25).

The Court of Appeals reversed the District Court. It held the regulation requiring a taxpayer using the unit-livestock-price method of valuing inventories to include in inventory at the unit value all livestock raised, whether held for breeding purposes or for sale, to be a proper exercise of administrative power, and that the taxpayer, having selected the unit-livestock-price method of valuing inventories, must assume its burdens as well as its benefits. It also held that the method chosen by the taxpayer to correct what he believed to be an error constituted a

change of accounting method requiring the prior consent of the Commissioner.

BASIS FOR FEDERAL JURISDICTION.

The jurisdiction of the United States District Court for the District of South Dakota was invoked by the petitioners pursuant to 28 U.S.C., 1958 Ed., Sec. 1346 (a) (1).

REASONS AND ARGUMENTS FOR ALLOWING THE WRIT.

I.

The Decision of the Court of Appeals Directly Conflicts with a Decision of the Court of Appeals for the Fifth Circuit.

The Court of Appeals decision in this case and the decision of the Court of Appeals for the Fifth Circuit in *Scofield* v. *Lewis*, 251 F.2d 128, represent diametrically opposed answers to the question raised by what is perhaps the last vestige of Governmental attempts to deny capital gain treatment of the entire proceeds of sales of breeding livestock. A complete understanding of the nature of this question necessitates a brief review of the history of the conflict over the applicability of Section 117 (j) of the Internal Revenue Code of 1939, Appendix B, *infra*, to the livestock industry. From the original enactment of that section in 1942, until its amendment in 1951, at which time it was made specifically applicable to livestock, regardless of age, held for breeding purposes, the Internal Revenue Service succeeded in finding a variety of theories upon which to oppose complete extension of its capital gain benefits to the livestock industry. All of these theories met with

defeat when tested by litigation, and the entire controversy appeared to have been terminated by the amendment of Section 117 (j) in 1951, as previously noted. The various developments in this area have been ably summarized by the Court of Appeals. Appendix A, pp. A9-A14, and they will not be repeated herein.

Nevertheless, the Internal Revenue Service continued to deny the full benefits of the capital gain provisions of Section 117 (j) to a segment of the livestock industry; *i.e.*, those livestock owners who used the accrual method of accounting and chose the unit-livestock-price method of valuing inventories. The denial is caused by the provisions of Section 1.471-6 (f) of Treasury Regulations promulgated under the Internal Revenue Code of 1954, Appendix B, *infra*. This regulation is identical to its predecessors and, therefore, has been in force since several years prior to the amendment of Section 117 (j) in 1951. See Treasury Regulations 118, Section 39.22(c)-6(f) and Treasury Regulations 111, Section 29.22 (c)-6, Appendix B, *infra*. The effect of the regulation is to require a taxpayer using the unit-livestock-price method of valuing inventories to include raised breeding livestock in inventory at the unit value, thus compelling him to accrue a cost basis for raised breeding stock, which must be deducted from gross sales price in order to determine net profit subject to the capital gain provision of Section 117 (j) and its successory Section 1231 (b) of the Internal Revenue Code of 1954, Appendix B, *infra*.

The continued existence of this regulation led to the litigation of *Scofield* v. *Lewis*, *supra*, the case conflicting with the decision of the Court of Appeals in the instant case. In the *Lewis* case, the taxpayers, who operated on an accrual method of accounting and chose the unit-livestock-price method of valuing inventories, had included breeding

stock in inventory for the years 1946 through 1949 pursuant to the requirements of the regulation in question. Subsequent to several of the judicial pronouncements that breeding stock was entitled to Section 117 (j) treatment, the taxpayers there filed claims for refund, claiming that they were entitled to capital gain treatment on the sale of their breeding livestock. That gain had originally been reported as ordinary income. They alleged that they were entitled to compute the amount of that capital gain on the entire proceeds of the sale of such stock, asserting that it properly had a zero basis in their hands. The Government recognized that the sales of the breeding livestock were entitled to capital gain treatment and, accordingly, allowed the claims for refund on the amount of the gain that exceeded the accrued inventory value.

The taxpayers brought suit for the disallowed portion of the claims, contending that they were entitled to remove the raised breeding livestock from inventory and claim a zero basis upon its sale. The district court[2] and the Court of Appeals for the Fifth Circuit held that the taxpayers were entitled to remove such raised breeding stock from inventory, that such removal did not constitute a change of accounting method requiring the Commissioner's consent, and that the taxpayers were entitled to a zero basis for their raised breeding livestock and, accordingly, to capital gain treatment of the entire proceeds of sale.

From the foregoing it is apparent that the *Lewis* case involved precisely the same fact situation as this case, with the exception of the manner in which the raised breeding stock was removed from inventory. Although it is never clearly stated, it would appear that the taxpayers in the

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2. Opinion not officially reported but found at 51 A.F.T.R. 1545 (W.D. Tex.).

Lewis case removed their stock from inventory entirely in the year of sale, whereas these taxpayers, having discovered the error earlier, removed their stock gradually, by amortizing the accrued inventory value over the period of the remaining useful lives of the animals. It is significant to note that this factual difference was not cited by the Court of Appeals as a reason for its refusal to follow the decision of the *Lewis* case.

A comparison of the results reached in these two cases involving such similar fact situations demonstrates beyond question that they are in direct conflict on every point involved.

LEWIS	EKBERG
1. The taxpayers are not required to include raised breeding livestock in inventory or to use the unit-livestock-price method to determine the cost of animals sold.	1. The taxpayers, having elected the unit-livestock-price method, must apply it to raised breeding livestock and include them in inventory.
2. Taxpayers using the unit-livestock-price method are entitled to a zero basis upon the sale of raised breeding livestock the same as taxpayers using other methods.	2. Because the taxpayers chose the unit-livestock-price method of valuing inventory, they are not entitled to a zero basis for raised breeding livestock.
3. Congress never intended to limit the extent of the capital gain available upon sale of raised breeding livestock because of	3. The taxpayer, having elected the unit-livestock-price method of valuing inventory must accept its burdens together with

the prior election by a taxpayer to use the unit-livestock-price method in valuing inventories.

its benefits. Therefore, the extent of the capital gain available to him upon sale of raised breeding livestock is limited to the excess of sale price over accrued cost basis.

4. Treasury Regulations 111, Section 29.22 (c)-6 were invalid because restrictive of Congressional intent in extending capital gain treatment to raised breeding livestock.

4. Treasury Regulations, Section 1.471-6(f), the successor of Treasury Regulations 111, Section 29.22(c)-6, constitutes a proper exercise of administrative power and is not inconsistent with Section 1231(b) of the Internal Revenue Code of 1954 or its predecessor.

5. Removal of raised breeding livestock from inventory for the purpose of achieving a zero basis thereon is not a change of accounting method requiring the permission of the Commissioner of Internal Revenue.

5. Removal of raised breeding livestock from inventory for the purpose of achieving a zero basis thereon is a change of accounting method which cannot be accomplished without the consent of the Commissioner of Internal Revenue.

6. Methods of accounting are not to be determinative of tax liability in this situation.

6. The taxpayer, having elected the unit-livestock-price method of valuing inventories, must assume its burdens together with

> its benefits, and so the election of the valuation method is determinative of his tax liability in this situation.

The conflict between the two results was expressly recognized by the Court of Appeals when it said, Appendix A, p. A19:

> "After careful consideration, however, we feel that *Lewis* should not be controlling here and, to the extent, if any, that it is in conflict with the conclusions we reach, we disagree with it and do not follow it."

The Court clearly indicated the extent of the conflict when it chose to take issue with the reasoning of the Fifth Circuit, instead of attempting to distinguish the factual situation presented by *Lewis* from that of this case. It stated that the Fifth Circuit was concerned solely with the contrast between the cost basis possessed by a taxpayer using the cash method of accounting and that possessed by a taxpayer using the accrual method, thereby omitting consideration of the advantages which an accrual basis taxpayer might possess. It also mentioned that the result of the *Lewis* case was predicated upon an assumed lack of an available and timely option for the taxpayer when he elected the unit-livestock-price method of valuing his inventory; whereas, the Court of Appeals here was of the opinion that the taxpayer had an opportunity to make a knowledgeable choice of methods at that time.

Lest it be thought that either the result or the reasoning of the *Lewis* case was in any way mitigated by the Fifth Circuit's decision in *Carter* v. *Commissioner*, 257 F.2d 595, which was apparently the impression of the Court of Appeals in this case, the significant factual differences of

Carter from *Lewis* and this case should be explored. The basic reason for the result reached by the *Lewis* case was that Section 29.22 (c)-6 of Treasury Regulations 111 required the raised breeding livestock to be included in the inventory of one using the unit-livestock-price method. However, the taxpayer in the *Carter* case had elected to use the farm-price method of valuing inventories, and, therefore, was not subjected to the requirement of which complaint was made both in *Lewis* and in this case. See Treasury Regulations promulgated under the Internal Revenue Code of 1954, Section 1.471-6(d), Appendix B, *infra*. In addition, the taxpayer in *Carter* had purchased his breeding herd, whereas the animals involved in *Lewis* and here had been raised. Examination of Section 1.471-6(f), of the Regulations, Appendix B, *infra*, discloses that there is no requirement that even one who uses the unit-livestock-price method include purchased breeding stock in inventory. Section 1.471-6(g) of the Regulations, Appendix B, *infra*, makes the inclusion of purchased breeding stock optional with such a taxpayer.

These factual differences then explain the statement in the *Carter* opinion to the effect that the *Lewis* case would be limited to its own facts, and that the result reached in *Carter* would have been no different had he been using the unit-livestock-price method, which he was not. For even under the unit-livestock-price method he would have had the option, which was not available to the taxpayer in *Lewis*, to inventory the stock or not as he chose.

II.

The Court of Appeals Has Erroneously Decided an Important Question of Federal Law Which Has Not Been, but Should Be Settled by This Court.

The importance of the federal question presented here, both from the standpoint of its effect on the public revenue

and of the number of taxpayers that may be influenced by it can be determined from several sources. The United States Department of Agriculture estimates that in 1959 the total cash income from farm marketing was $33,827,000,000. Income from meat represented 32.6% of this total.[3] The total gross income derived from red meat animals in 1959 was $11,322,997,000.[4] The Department also estimates that approximately 85% of all farms in the United States in 1959 had at least one of the red meat species.[5]

When these figures are considered in the light of the Government's estimate, made in its brief filed in the Court of Appeals, that approximately 75% of ranchers in the United States now use the accrual method of accounting, the scope and importance of this question become evident Thus, the problem is bound to arise in other jurisdictions, as is already evidenced by *Little* v. *Commissioner*, 34 T.C. 156, affirmed (C.A. 9th), decided July 7, 1961, docket number 17,185, not yet officially reported, but found at 8 A.F.T.R. 2d 5124, in which the Court of Appeals for the Ninth Circuit reached a decision conforming to that reached by the Court of Appeals in this case, on a question of similar nature.

These three Court of Appeals decisions, then, represent the only judicial authority on the question presented. Unless some taxpayers are to have an advantage not available to others simply because they live in a given geographical area, this Court must supply a definitive answer to the con-

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3. Farm Income Situation, Agricultural Marketing Service, United States Department of Agriculture.

4. Meat Animals, Farm Production, Disposition, and Income, by states, 1955-1959 Revised Estimates; United States Department of Agriculture, Crop Reporting Board, May, 1961.

5. Agricultural Census 1960.

flict presented by these decisions. Uniform administration of the revenue laws cannot continue in the face of such discord.

CONCLUSIONS.

For the reasons expressed herein it is submitted this petition for a writ of certiorari should be granted.

Respectfully submitted,

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and
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Attorneys for Petitioners.

September, 1961.

APPENDIX A.

United States Court of Appeals

FOR THE EIGHTH CIRCUIT.

No. 16,539

United States of America, Appellant, vs. Harold M. Ekberg and Secrie Ekberg, Appellees.	Appeal from the United States District Court for the District of South Dakota.

[June 21, 1961.]

Before JOHNSEN, Chief Judge, and VOGEL and BLACKMUN, Circuit Judges.

BLACKMUN, Circuit Judge.

This case involves questions of federal income tax accounting and return treatment of a rancher's breeding cattle for the calendar years 1954, 1955 and 1956.[1] In the center of the controversy are (a) the 1954 Internal Revenue code's § 1231(b)(3), defining breeding livestock held 12 months or more as "property used in the trade or business", and (b) § 1.471-6(f) of the Code's Regulations providing:

> "A taxpayer who elects to use the 'unit-livestock-price method' must apply it to all livestock raised,

1. Two minor issues were contested in the trial court. One was decided in favor of the taxpayers and one against them. These issues are not before us on this appeal.

whether for sale or for draft, breeding, or dairy purposes. * * *"

Two questions are presented:

1. Was this taxpayer, under Regs. § 1.471-6(f), improperly required to subject his raised breeding livestock to the unit-livestock-price method?

2. May the taxpayer recover his breeding stock's unit values through amortization deductions?

The taxpayers are husband and wife.[2] They timely filed joint federal income tax returns for each of the three taxable years involved. They reside in Harding County, South Dakota. There Mr. Ekberg owns and operates a ranch of substantial acreage. For some years he has been engaged in the business of raising high quality purebred Aberdeen Angus cattle. For that purpose he constantly has maintained a breeding herd in addition to his other cattle. Additions to this herd are made only with heifers which he has raised; no additions are made through purchase. All heifer calves born in the breeding herd are held for breeding purposes until designated otherwise.

The taxpayer has kept his books and records on the accrual basis of accounting; because of this, he has been required by the applicable Regulations,[3] § 1.61-4(b), to use inventories to determine gross income. He has also employed the "unit-livestock-price method" of valuing his

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2. Mrs. Ekberg's interest lies in the fact that she filed joint returns with her husband. The ranch operations herein described are those of Mr. Ekberg. Any reference to the "taxpayer" in the singular, while primarily directed to him, is applicable to both husband and wife.

3. Hereinafter, unless otherwise described, section references are to the 1954 Code and to 26 U.S.C.A., and regulations references are to the Regulations issued under the 1954 Code.

livestock inventory; because of this, he has been required by the applicable Regulations, § 1.471-6(f) to apply that method to his breeding livestock as well as to his cattle held for sale. Specifically, he has assigned, in the taxable year of birth, a full unit price of $70 to each new heifer. Evidently this unit evaluation has met with the approval of the District Director of Internal Revenue for it is not now questioned.

This addition to inventory at the unit price of each new heifer in the breeding herd results in an increase in the taxpayer's ordinary income for the taxable year and in a reduction in the gain, if any, upon the animal's subsequent disposition. If, in contrast, the taxpayer could carry each breeding animal at a zero basis, as would be the case if he used the cash receipts and disbursements method, its birth would not create ordinary income, its net disposition price would constitute gain in its entirety rather than in part, and, with all other qualifying factors satisfied, that gain would be afforded capital gains treatment rather than ordinary income treatment. The taxpayer presumably, as is the case for each of the three taxable years here, would then enjoy a lower income tax.

Mr. Ekberg endeavored to obtain this tax-benefit. He encountered opposition, however, from the tax authorities because of his use of the accrual-inventory method of accounting and of the unit-livestock-price method of evaluation. In 1951 and again in 1952 he was not permitted to remove his breeding cattle in its entirety from inventory and to reduce in one year each head's $70 unit value to zero. He then adopted another approach. In 1954 he removed from inventory only his yearling heifers in the breeding herd and, instead, included and expressly described them among other assets in his return's depreciation schedule. A deduction for "depreciation" upon the

heifers, computed so as to recover the existing unit valuations over a six-year period, was taken. He did the same thing in 1955 and 1956. The Internal Revenue Service disallowed these deductions.[4] Deficiency assessments resulted and were paid.

The present action is to recover those payments. The case was tried to the court sitting without a jury and resulted in judgment for the plaintiffs. The government has appealed.

The trial court found as a fact that the taxpayer "without the consent of the Commissioner of Internal Revenue, changed the 'accrual method' of reporting * * * income, but only to the extent of transferring breeding livestock * * * carried in inventory under the 'unit-price method' to the depreciation schedule". It also found that the Commissioner's consent for this was not required. It concluded, largely upon the authority of *Scofield* v. *Lewis*, 5 Cir., 251 F.2d 128, that the taxpayer had the right unilaterally to make this change and to claim the "depreciation" deductions, that this did not amount to a change in accounting method, and that the taxpayer, by the deductions, "achieved" capital gains treatment approximating that accorded breeders on a cash basis.

Two things merit initial mention:

(a) We are not concerned here with the question whether the taxpayer's net gains realized upon the disposition of breeding cattle and other property "used in the trade or business", and held for the required period

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4. Supposedly (although the record before us is not clear as to this), the Service correspondingly refused to permit capital gains treatment of the *entire* difference between sale price and carrying value, as reduced by these deductions, upon the disposal of breeding animals during these years.

of time, are entitled to capital gains treatment. The government concedes this. Among the many cases so holding are *Albright* v. *United States*, 8 Cir., 173 F.2d 339, and *United States* v. *Cook*, 8 Cir., 270 F.2d 725. This is so even though the taxpayer has included his breeding stock in inventory. *Fawn Lake Ranch Co.*, 12 T.C. 1139, 1144, appeal dismissed, 8 Cir., 180 F.2d 749; *SoRelle*, 22 T.C. 459, 473-4; *Estate of C. A. Smith*, 23 T.C. 690, 705; *Scofield* v. *Lewis*, *supra*; *Carter* v. *Commissioner of Internal Revenue*, 5 Cir., 257 F.2d 595; *Herbert A. Nieman & Co.*, 33 T.C. 451, 462.

(b) The case is rendered somewhat confusing by the taxpayer's questionable use of the word "depreciation" to describe his claimed amortization of unit evaluations and by his inclusion of breeding cattle in his returns' depreciation schedules. The deductions claimed as "depreciation" are actually items asserted, with respect to animals which had not reached maturity, in order to counteract, by amortization, the prior inclusion in inventory and ordinary income of breeding animals at birth at the unit evaluations. We therefore are not dealing with the usual income tax concept of depreciation related to exhaustion and wear and tear of trade or business or income producing property provided for under § 167(a). True depreciation of that kind is not assertable on inventory livestock. Regs. § 1.167(a)-6(b); *SoRelle*, *supra*, p. 474 of 22 T.C.; *Frost*, 28 T.C. 1118.

The government's position is that this taxpayer has freely selected and uses the accrual-inventory method of accounting and the unit-livestock-price method of evaluation; that his breeding livestock is raised, not purchased; that it has been carried in inventory; that it cannot now be removed from inventory without the Commissioner's

consent because this involves a change of accounting method; and that the Commissioner has not given his consent.

The taxpayer's position is that he is entitled to remove his raised breeding livestock from inventory and to achieve a zero income tax basis for it because of the policy behind § 1231(b)(3) to provide broad tax benefit for breeding livestock raisers; that his livestock was placed in inventory because Regs. § 1.471-6(f) requires it; that this requirement was rendered obsolete with the statutory change effected in § 1231's predecessor by the Revenue Act of 1951 and is now improper; that he may amortize his improperly-required inventory valuations by appropriate annual deductions; and that so doing does not effect a change in accounting method which needs the Commissioner's consent.

Because the case concerns involved farm accounting problems, it is desirable to review the applicable provisions of the 1954 Code and of its accompanying Regulations and then to emphasize some features of their relevant history. We do this in the margin.[5]

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5. *The Code and the Regulations.* A taxpayer's taxable income shall be computed upon the accounting method by which his books are kept. § 446(a). Recognized and permitted general methods of accounting include the cash receipts and disbursements method, an accrual method, and combinations of these. § 446(c). The cash receipts and disbursements method generally contemplates the inclusion of income for the year in which received and the allowance of deductions for the year in which paid. The accrual method generally relates income and deductions to the year in which earned or incurred. Regs. § 1.446-1(c)(i) and (ii). A taxpayer filing his first return may adopt any permissible method of accounting. Regs. § 1.446-1(e)(1). Once having chosen his method, however, the taxpayer, if he wishes to change it and before computing his taxable income under a new method, must secure the consent of the Commissioner. § 446(e) and Regs. § 1.446-1(e)(2).

The Code and Regulations in summary provide that:

a. A farmer or rancher may use either a cash receipts and disbursements method or an accrual method of accounting.

b. Once having selected his accounting method, it is binding upon him for income tax purposes for subsequent years unless the Commissioner consents to a change.

c. If he uses an accrual method, he must use inventories.

A farmer—and this includes a rancher such as the taxpayer here, Regs. § 1.61-4(d)—has, as does any other taxpayer, the same initial choice of accounting method. He may use the cash receipts and disbursements method or he may use an accrual method. Having elected one method, he must stay with it for subsequent years unless authorized by the Commissioner to change his method. Regs. § 1.471-6(a). If, however, he uses the accrual method then he must use inventories to determine his gross income. Livestock raised or purchased for sale shall be included in the inventory at their proper valuation, and livestock "acquired for draft, breeding, or dairy purposes and not for sale may be included in the inventory * * * instead of being treated as capital assets subject to depreciation, provided such practice is followed consistently from year to year by the taxpayer". Regs. § 1.61-4(b).

§ 471 relates to inventories. A taxpayer's inventory practice "should be consistent from year to year". Regs. § 1.471.2(b). While the most commonly used valuation bases are (1) cost or (2) cost or market, whichever is lower, Regs. § 1.471-2(c), it is recognized that there is "difficulty of ascertaining actual cost of livestock and other farm products". As a consequence, farmers who raise livestock "may value their inventories of animals according to either the 'farm-price method' or the 'unit-livestock-price method' ". Regs. § 1.471-6(c). The farm-price method provides for valuation at market price less direct cost of disposition. Regs. § 1.471-6(d). The unit-livestock-price method provides for valuation of different classes of animals at a standard unit price (which is reasonably to account for the normal costs incurred) for each animal within a class. Regs. § 1.471-6(e). Then Regs. § 1.471-6(f), quoted *supra*, provides that a taxpayer who elects

d. If he uses inventories and if he raises livestock, he must value that livestock for the inventory either by the farm-price method or by the unit-livestock-price method.

e. If he uses inventories and if he raises livestock and if he uses the unit-livestock-price method of evaluation, he must apply that method to all livestock *raised*, including breeders, but as to breeding livestock *purchased* he has the option of including it in inventory or of treating it as a capital asset subject to depreciation after maturity.

f. His breeding livestock held a year or more qualifies as property used in the trade or business.

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to use the unit-livestock-price method *must* apply it to all livestock *raised* including breeding animals. This means that a livestock raiser who uses this method cannot segregate his *raised* breeding herd and treat it as though it were a capital asset subject to depreciation after maturity. In contrast, a livestock raiser who uses the unit-livestock-price method must include in his inventory at cost any livestock *purchased* "except that animals purchased for draft, breeding, or dairy purposes can, at the election of the livestock raiser, be included in inventory or be treated as capital assets subject to depreciation after maturity". Regs. § 1.471-6(g). The Regulations thus distinguish between *raised* breeding livestock and *purchased* breeding livestock for a taxpayer using the unit-livestock-price method.

§ 167(a) permits, as one of the itemized deductions, a reasonable allowance for depreciation of property used in the trade or business. "Livestock acquired for work, breeding, or dairy purposes may be depreciated unless included in an inventory used to determine profits. * * *"

§ 1201 *et seq.* concern capital gains and losses. It is usually to the advantage of a taxpayer to be able to treat a gain as a capital gain rather than as ordinary income. § 1221 defines the term "capital asset" to mean generally "property held by the taxpayer". Excluded from this definition, however, are stock in trade; inventory property; property held primarily for sale in the ordinary course of business; property used in the trade or business, subject to the depreciation allowance; and certain other described property. Inasmuch as ranching is a trade or business,

The history of the Code and Regulations shows that:

a. Regs. § 1.471-6(f), with its emphasis on *raised* breeding livestock and on the compulsory extension to it of the unit-livestock-price method, when that method has once been selected by the rancher, originated in 1944.

b. Specific statutory references to breeding livestock and its inclusion in the definition of "property used in the trade or business" appeared in the statute for the first time with the 1951 Act (although made retroactive to taxable years beginning after 1941).

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livestock, under § 1221, is outside the definition of capital assets whenever it is inventory property or is "held * * * primarily for sale" or is "used" in the business and subject to the depreciation allowance. § 1221, however, does not stand alone. Accompanying it is § 1231 which relates to "property used in the trade or business" and provides capital gains treatment for net gains realized upon the disposition of this kind of property. § 1231(b) defines "property used in the trade or business" and § 1231(b)(3) has this definition specifically include "livestock, regardless of age, held by the taxpayer for draft, breeding, or dairy purposes", for 12 months or more. The Regulations, of course, recognize the application of § 1231 to draft, breeding, or dairy livestock. Regs. § 1.1231-1(c)(4). The term "livestock", furthermore, "is given a broad, rather than a narrow interpretation". Regs. § 1.1231-2(a).

The History of the Statute. § 117 of the 1939 Code concerned capital gains and losses and corresponds with § 1201 *et seq.* of the 1954 Code. § 117(a) gave the same broad general definition to "capital assets" as does the present § 1221 and then excluded from that definition the same 4 categories of stock in trade, inventory property, property held primarily for sale to customers in the ordinary course of business, and property, used in the trade or business, subject to the depreciation allowance. (It contained, however, none of the present Code's exclusionary references to discounted obligations, trade or business real estate, copyrights and the like, and accounts and notes receivable. The first three of these exclusions appeared in § 117(a) by way of amendments effected by the Revenue Acts of 1941, 1942 and 1950, respectively, and the last came only with the 1954 Code.)

c. The Regulations paragraph which the present taxpayer finds offensive under the 1954 Code thus antedated the statute by almost 7 years.

d. This Regulations paragraph is one issued under the Code's § 471 which has to do with inventories, whereas breeding livestock's qualification for capital gains treatment, so far as the statute is concerned, lies in § 1231 (b)(3).

e. The question precisely presented, therefore, is whether this preexisting paragraph of the Regulations under § 471 has valid application to this taxpayer for calendar years subsequent to the change effected by the 1951 Act in what is now § 1231(b)(3).

There was nothing in the 1939 Code, as originally enacted, which corresponded to § 1231 of the 1954 Code relating to property used in the trade or business. § 1231's predecessor was § 117(j) of the amended 1939 Code; it appeared, however, only when it was added by § 151(b) of the Revenue Act of 1942. This new § 117(j) defined "property used in the trade or business" to be property so used which was subject to the depreciation allowance and held for more than 6 months, and trade or business real property held for more than 6 months, which was not inventory property or held primarily for sale. (Subsection (j)'s inclusion of timber and of coal in the definition were added by the Act of February 25, 1944, 58 Stat. 46, 47, and by the Revenue Act of 1951, respectively, and its exclusion of copyrights, etc. from the definition was effected by the Revenue Act of 1950.) Not until the enactment of the Revenue Act of 1951, § 324, did § 117(j) of the 1939 Code include within its definition of "property used in the trade or business" the present specific reference to "livestock, regardless of age, held by the taxpayer for draft, breeding, or dairy purposes", for 12 months or more, now found as § 1231 (b)(3) of the 1954 Code. This part of the 1951 amendment, however, by its terms was made applicable to taxable years beginning after 1941.

History of the Regulations. Regulations 111 relate to the 1939 Code. § 29.22(c)-6 thereof, as originally issued on October 26, 1943, concerned inventories "of livestock raisers and other

So much for the bare aspects of the Code, the Regulations and their history. Statutory changes, however, are often prompted by decided cases and administrative attitude. We find here that developments along this line were forthcoming and are revealing. We list chronologically those which are particularly emphasized by the parties:

(a) I.T. 3666, 1944 C.B. 270, was issued in response to an inquiry concerning the application of the 1939 Code's § 117(j) (as it read after the 1942 Act and before the

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farmers". It stated that, "because of the difficulty of ascertaining actual cost of livestock and other farm products, farmers who render their returns upon an inventory basis may value their inventories according to the 'farm-price method.' * * *" It contained no specific mention of breeding livestock. This section was amended in December, 1944, by T. D. 5423, 1945 C.B. 70. This permitted farmers raising livestock to value inventories according to either the farm-price method or the unit-livestock-price method. It amended existing paragraphs to conform (except for minor particulars not pertinent here) with the present Regs. § 1.471-6(c) and (d) and added new material identical (except for inconsequential details) to the present Regs. § 1.471-6(e) to (h), inclusive. That portion of Regs. § 29.22(c)-6, as so amended in 1944, which corresponds to the present Regs. § 1.471-6(f), read as follows:

> "A taxpayer who elects to use the 'unit-livestock-price method' must apply it to all livestock raised, whether for sale or for breeding, draft, or dairy purposes. Once established, the unit prices and classifications selected by the taxpayer must be consistently applied in all subsequent years in the valuation of livestock inventories. No changes in the classification of animals or unit prices will be made without the approval of the Commissioner."

(This language also appears in Regs. 118, § 39.22(c)-6, issued in 1953 and applicable to taxable years beginning after 1951.) Sec. 29.117-7 of Regulations 111, relating to capital gains treatment on the disposition of certain non-capital assets, was amended by T. D. 5970, issued January 6, 1953, 1953 C.B. 183, to include provisions applicable to draft, breeding or dairy-purpose livestock, and was occasioned by the change in the statute effected by the 1951 Act.

1951 change) to gains and losses upon the disposition of draft, breeding or dairy livestock. The ruling clearly shows that the Bureau of Internal Revenue regarded the benefits of § 117(j) as available to the farmer irrespective of whether the livestock was raised or purchased, of whether the accrual or cash basis was used and of whether the stock was or was not inventoried. However, animals culled from the herd in the regular course of business were denied this treatment.

(b) I.T. 3712, 1945 C.B. 176, resulted from confusion arising out of the qualification just mentioned. It established an abnormal-normal sales test for determining whether sales of livestock were or were not entitled to the benefits of § 117(j). It set up a *prima facie* standard that reductions in the herd would be presumed to be of animals held for breeding purposes but that additions to the herd would occasion ordinary income treatment for animals sold.

(c) A letter dated August 4, 1947, issued from the Commissioner in response to an inquiry from the Chairman of the Senate Finance Committee. See *Albright*, *supra*, p. 343 of 173 F.2d. The Commissioner here adhered to the position taken in the two I.T. rulings relative to the sale of culls as ordinary income, acknowledged that the solution depended upon the facts of each case, and stated that the term "culls" also represented animals regularly sold from the breeding herd in order to keep it at a desired size.

(d) In 1949 *Albright* v. *United States*, 173 F.2d 339, was decided by this court with one dissent. This concerned the proper tax treatment of 1945 and 1946 profits realized upon sales of livestock from a dairy herd and from a breeding hog herd. The court reviewed § 117(j) of the 1939 Code, as then amended, and the three rulings and

held that net gains realized upon the disposition of such property were entitled to capital gains treatment by a taxpayer on the cash receipts and disbursements basis. It noted that § 117(j) "provided an entirely new method of reporting gains and losses on the sale of noncapital assets used in the trade or business" and that the taxpayer's sales were prompted by a need to maintain his herd at an appropriate size. This court refused to accept the restriction of the prior rulings to sales aimed at herd reduction and concluded that "the interpretations of the Commissioner are contrary to the plain language of § 117(j) and to the intent of the Congress expressed in it"," pp. 344-5 of 173 F.2d.

(e) Mim. 6660, 1952-2 C.B. 60, was issued following *Albright* and *United States* v. *Bennett*, 5 Cir., 186 F.2d 407, which had reached the same result. The ruling stated that the Service had reexamined its position. It held that gains realized from the sale of breeding animals came within the purview of § 117(j) if it was established "that the particular animals sold were actually used for dairy, draft or breeding purposes for substantially their full period of usefulness". This thus still denied generally the benefit of § 117(j) to younger animals. I.T. 3666 and I.T. 3712 were revoked.

(f) Senate Report No. 781, 82d Cong., 1st Session, 1951-2 C.B. 458, 487, contained comments upon the changes proposed in § 117(j) by the then pending Revenue Act

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6. *Albright* was followed by the 5th Circuit in *United States* v. *Bennett*, 1951, 186 F.2d 407, by various United States District Courts *Mitchell* v. *United States*, N.D. Cal., 1951, 96 F. Supp. 473, 474; *Miller* v. *United States*, D. Nebr., 1951, 98 F. Supp. 948; *Colvert* v. *United States*, E.D. Okla., 1951, 101 F. Supp. 673, and by the Tax Court, *Emerson*, 1949, 12 T.C. 875; *Fawn Lake Ranch Co.*, 1949, supra; and *Flato*, 1950, 14 T.C. 1241, 1250, affirmed on other grounds, 5 Cir., 195 F.2d 580.

of 1951. It recited the existence of "considerable confusion and dispute for several years" as to the use or sale aspects of livestock held for breeding purposes. It referred to the two I.T. rulings, to *Albright* and *Bennett*, to Mim. 6660, and to "new uncertainties" resulting from this last ruling. It stated that in view of these uncertainties the House bill was being expanded by the Senate so as to include livestock "regardless of age" held by the taxpayer for breeding, etc., purposes for a year or more.

(g) Mim. 6776, 1952-1 C.B. 71, issued after the 1951 Act. It revoked Mim. 6660 and held that, with the addition to the statute effected by the Act, "under appropriate circumstances" gains from sales of breeding livestock were subject to capital gains treatment. The two I.T. rulings were not thereby reinstated.

(h) *Scofield* v. *Lewis, supra*, 5 Cir., 1958, 251 F.2d 128, concerned cash basis taxpayers who were members of an accrual basis ranching partnership. The years involved were 1946 through 1949. The partnership sold animals from its breeding herd. It included its breeding livestock, from 1939 on, in inventory and used the unit-livestock-price method. After the decisions in *Albright* and *Fawn Lake*, *supra*, and in *Emerson*, 12 T.C. 875, the taxpayers filed claims for refund for the differences between the taxes paid on their profits from sales of breeding stock at ordinary income rates and the amounts they would have paid on a capital gains approach. The government claimed that the taxpayers, having used the unit-livestock-price method, could not change to a cash basis and take breeding stock out of inventory without the Commissioner's consent. The district court entered judgment for the taxpayers. The 5th Circuit affirmed. It stressed the requirement of the Regulations to the effect that if the unit-live-

stock-price method was used for the sale herd it also had to be used for breeding animals and concluded that this was an unreasonable restriction. It found nothing in the 1951 amendment or in the original statute which indicated a congressional design to limit capital gains treatment because of prior use of the unit-livestock-price method. It held that the entire sales price was entitled to capital gains treatment and that it was not to be limited to that portion thereof in excess of inventory value.[7]

(i) *Carter* v. *Commissioner of Internal Revenue, supra,* 5 Cir., 1958, 257 F.2d 595, involved a taxpayer using inventories and the farm price method. The court denied the taxpayer's claim that the capital gains treatment to which he was entitled with respect to his purchased livestock should be measured from cost rather than from inventory figures. In response to his reliance upon *Lewis,* the court observed that *Lewis* was not to be extended "beyond its own facts". The earlier case was held not to apply to this taxpayer-purchaser because, under the Regulations and in contrast to the *Lewis* situation, he possessed the option to carry the animals in inventory or to treat them as capital assets and had made his choice. A change in that choice would amount to a change in the method of accounting and was not permissible. *Gibbs,* 33 T.C. 27, 30, is to the same effect. See also Rev. Rule 60-60, 1960-1 C.B. 190.

These rulings and cases enable us to make certain additional observations:

a. Controversy and litigation have centered primarily upon the question whether particular livestock qualifies as

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7. It is not apparent from the opinion just how the reduction to zero basis was effected. One may presume that it was accomplished by removal from opening inventory. Compare *Little,* 34 T.C. 156.

breeding stock, so as to be entitled to capital gains treatment, and, secondarily, upon the question of proper basis. The former, as has been noted above, is not involved here.

b. In spite of the Bureau's recognition, as far back as I.T. 3666 in 1944, that raised breeding livestock, if held for the required period was entitled to the benefit of the 1939 Code's § 117(j), even though it had been inventoried, there is much to be said for the taxpayer's forceful suggestion that the Commissioner, as a practical matter, and largely without success, has consistently resisted and attempted to limit the allowance of capital gains treatment to breeding livestock.

c. These authorities, and other decided cases, conclude, however, that cattle, once its status as raised breeding livestock is established, is entitled on disposition to have net gains treated as capital gains.

d. The Service's successive restrictions in its rulings, and its application of Regulations 111, § 29.22(c)-6, as amended (corresponding with the present Regs. § 1.471-6 (f)), to a unit-livestock-price method taxpayer's raised breeding livestock in the single litigated case involving that narrow issue, have been held invalid.

With this background material we come down to the two questions presented by this case:

1. The validity of Regs. § 1.471-6(f). Clearly this requires that the taxpayer, once having selected the unit-livestock-price method, must apply it to his breeding livestock. Just as clearly, as has been shown above, this was the requirement of the Regulations prior to the 1951 change in the statute. It is on this chronological fact that the taxpayer primarily rests his claim of invalidity of the Regulation's application to him.

We have recently reiterated, with supporting citations, that administrative construction of a statute is entitled to great weight; that regulations are to be sustained unless unreasonable and plainly inconsistent with the statute; that one who claims that a regulation is invalid has the heavy burden of so demonstrating; that regulations, however, cannot be arbitrary; and that they must have a basis in the statute and be within the authority granted the administrative agency. *Review Committee Venture VII, etc.* v. *Willey*, 8 Cir., 275 F.2d 264, 272, cert. den. 363 U.S. 827.

On the other hand, we must recognize (a) that the capital gains provisions of the Code were intended as a relief measure, *Helvering* v. *Bliss*, 293 U.S. 144, 148; (b) that the same is to be said of those provisions added by the Revenue Act of 1942 as subsection (j) to § 117 of the 1939 Code, and of the livestock reference added to § 117(j) by the Revenue Act of 1951, *Albright* v. *United States, supra*, p. 344 of 173 F.2d; *United States* v. *Cook, supra*, p. 728 of 270 F.2d; *Hazard*, 7 T.C. 372, 376; *Farry*, 13 T.C. 8, 13; *Fawn Lake Ranch Co., supra*, pp. 1143-4 of 12 T.C.; (c) that there is nothing in the statute which indicates an intent on the part of Congress to deny the Act's relief to any taxpayer whose transactions meet the prescribed conditions, *Albright* v. *United States, supra*, p. 344 of 173 F.2d; *Emerson, supra*, p. 879 of 12 T.C.; *Scofield* v. *Lewis, supra*, p. 132 of 251 F.2d; and (d) that the statute, in its application to livestock, "is not to be given more liberal treatment than when applied to any other asset covered by the section". Clark, 27 T.C. 1006, 1014.

Was this taxpayer arbitrarily or unreasonably restricted by Regs. § 1.471-6 (f) so that he was denied the relief intended by Congress? He claims that he was, that his breeding stock was included in inventory only because he

was compelled so to include it by this Regulation, and that *Scofield* v. *Lewis*, *supra*, is in point in his favor. The *Lewis* case does indeed frown upon what it regards as an element of compulsion and does provide some support to the taxpayer's position when it holds the Regulations section invalid in its ultimate effect upon income tax basis. That case, as this one does, involved accrual accounting (in the partnership), the use of inventories, and the unit-livestock-price method. The 5th Circuit said, p. 132 of 251 F.2d:

> "A taxpayer in the business of raising cattle who maintained breeding stock as well as a herd raised for sale could not, under the Regulations, elect to use the unit-livestock-price method of inventory values as to the herd raised for sale without using the same method as to the breeding animals and thus be required to use an accrued basis as cost upon making sales. As to a taxpayer who had commenced such procedure before the decision in the *Albright* case and those subsequent to it, the Commissioner insisted that the unit-livestock-price inventory accruals be continued until his consent was given to a change, and at the same time refused to consider any applications to remove the breeding stock from the inventories. This, we think, was not what the Congress intended. We find nothing in the 1951 amendment to Section 117(j), or for that matter in the Section as originally passed, indicating a Congressional design to limit the extent of capital gains treatment accorded to taxpayers selling animals from a breeding or dairy herd because of their prior election to use the unit-livestock-price method. The problem involves accounting practices and, to be sure, methods of accounting in some circumstances may be determinative of tax liability, but such is not the case here. Animals in a breeding herd are capital assets * * *."[8]

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8. The characterization in the quoted language of breeding livestock as "capital assets" is, of course, not technically correct.

After careful consideration, however, we feel that *Lewis* should not be controlling here and, to the extent, if any, that it is in conflict with the conclusions we reach, we disagree with it and do not follow it. Our reasons for so doing are:

a. The Court itself, in *Lewis*, emphasized, p. 131 of 251 F.2d, that the sole issue there was that of proper tax basis. This aspect permeates the case. The Court was concerned with the contrast in basis possessed by the cash accounting taxpayer and that possessed by the accrual accounting taxpayer. No mention was made of the possible advantages which a non-zero basis accrual taxpayer possesses. Some of these have since been noted in *Little*, 34 T.C. 156, 159:

> "There are advantages in using such a method. There may be years, particularly while such a business is in its formative stage, when expenses exceed income and deductions are not beneficial. Taking raised breeding animals into inventory under the 'unit-livestock-price' method would result in reporting some income for those years to offset expenses. The amount taken into inventory in any year is available as a basis when culls are sold and is also a basis

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§ 117(j) of the 1939 Code, as amended, and § 1231(b)(3) do not so define such livestock. These sections merely allow net gains on the disposition of certain trade or business property to receive capital gains treatment. This may or may not be a distinction without a difference. The term "capital assets" has been employed elsewhere. See, for example, *Greer*, 17 T.C. 965, 970; *Fox* v. *Commissioner of Internal Revenue*, 4 Cir., 198 F.2d 719, 723. In other cases, however, such assets have been carefully described not as capital assets but as items the net gains of which are entitled to capital gains treatment. See, for example, *Albright* v. *United States*, *supra*, p. 342 of 173 F.2d; *Fields*, 14 T.C. 1202, 1215, and the same case on appeal, *Fields* v. *Commissioner of Internal Revenue*, 2 Cir., 189 F.2d 950, 951; *Fox*, 16 T.C. 854, 860, which is the same case, *supra*, affirmed on appeal by the 4th Circuit.

against which to compute depreciation while the animals are used for breeding purposes. There are no doubt other advantages to taxpayers using such an inventory method."

b. *Lewis* was definitely limited by *Carter*, *supra*, decided by the same court only five months later. There it was said, pp. 600, 601, of 257 F.2d:

"In the first place we think the principle of the *Lewis* case should not be extended beyond its own facts. * * * We therefore conclude that *Scofield* v. *Lewis* would have no application to the facts here, even if this taxpayer had been on the 'unit-livestock-price method' or (of) accounting which he was not."

c. *Lewis*, it seems to us, goes off on the assumed lack of an available and timely option for the taxpayer. Being on the accrual-inventory method of accounting and being on the unit-livestock-price system of evaluation, the taxpayer by the Regulation did not have the choice between inventorying or capitalizing his raised breeding livestock as he would have had, with respect to any purchased breeding livestock, under § 29.22(c)-6, as amended, of Regulations 111, the predecessor to the present Regs. § 1.471-6(g). The taxpayer, however, was in this position as a result of his own initial selection of the unit-livestock-price system. This initial option he possessed under that portion of Regulations 111, § 29.22(c)-6, as amended, corresponding to Regs. § 1.471-6(a) and (c). He could have selected the farm-price method of evaluation or the cash method of accounting. Having selected his system as a matter of free choice, he must assume its burdens as well as its benefits.

d. The fact that the Regulation complained of antedated the 1951 change in the statute is no answer. If this fact stood alone it might be significant. The 1951 inclusion,

by what is now § 1231(b)(3), of breeding livestock within the definition of property used in the trade or business, however, added nothing to the law as it theretofore stood and as it had been interpreted. I.T. 3666, *supra*, itself recognized the availability of § 117(j) of the 1939 Code, as amended, to breeding livestock and *Albright* and the other cases cited above were consistently to the same effect. The statute came into being not because of contrary case law which Congress disapproved but because of the Commissioner's continuing reluctance to give full application of the statute to breeding stock:

> "The purpose of the 1951 amendment was chiefly to clarify the issue and to recognize by statutory enactment the rulings which had been made by the Courts as hereinabove indicated." *Gotfredson* v. *Commissioner of Internal Revenue*, 6 Cir., 217 F.2d 673, 676, cert. den. 350 U.S. 846.
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> "Even before the 1951 amendment, courts and the Commissioner have recognized this." *Estate of C. A. Smith*, *supra*, p. 705 of 23 T.C.
>
> "Secondly, the legislative history of the amendment unmistakenly demonstrates that Congress considered the amendment to be a codification of the *Albright* and *Bennett* decisions." *McMurtry*, 29 T.C. 1091, 1093, affirmed per curiam, 5 Cir., 262 F.2d 589.

See, also, *McDonald* v. *Commissioner of Internal Revenue*, 2 Cir., 214 F.2d 341, 343; *Laflin* v. *United States*, D. Nebr., 100 F. Supp. 353, 360, appeal dismissed 8 Cir., 194 F.2d 709.

The taxpayer, therefore, is not in a position to claim that the 1951 statute presented new elements which rendered his prior option selection meaningless and unfair. As the Tax Court said in *Little*, *supra*, pp. 158-9 of 34 T.C.:

> "There is no reason to conclude that Andrew was forced to use the 'unit-livestock-price' method of inventorying his sheep and cattle. He had some choice in this matter when he undertook this business. * * * This Court is in no position to say in this case that the inventory method which Andrew chose and consistently followed and which the Commissioner has followed in computing the gain from the sale of these culled cattle was an improper method."

It is true that this taxpayer has been in the business of raising breeding cattle since a year or so prior to this court's *Albright* decision. *Albright*, however, was concerned with the sale of so-called culls and the application of the 1939 Code's § 117(j) thereto. As we have noted, I.T. 3666, which was issued in 1944, and thus well before the taxpayer's selection of the accrual-inventory method and of the unit-livestock-price evaluation system, clearly recognized that capital gains treatment was available for the disposition of breeding cattle if all other necessary elements were satisfied. We conclude that the taxpayer at the inception of his business was not denied the opportunity of making a considered and meaningful choice of available options.

2. The propriety of the taxpayer's attempt to recover his unit values. What we have just said on the first question is perhaps dispositive of the case. The second point, however, deserves comment.

The Commissioner has the power to prohibit a taxpayer's change of accounting method without the Commissioner's consent. *Brown* v. *Helvering*, 291 U.S. 193, 203; *St. Paul Union Depot Co.* v. *Commissioner of Internal Rev.*, 8 Cir., 123 F.2d 235, 239; *Advertisers Exchange, Inc.*, 25 T.C. 1086, 1092-3, affirmed per curiam, 2 Cir., 240 F.2d 958. The question then is whether this taxpayer has attempted to make a change in accounting method. Regs.

§ 1.446-1(e)(2)(i) describes a "change" to include one "in the overall method of accounting for gross income or deductions" and also one "in the treatment of a material item". Subparagraph (ii) sets forth examples, among which are "a change involving the method or basis used in the valuation of inventories" and "a change in the treatment of any other items of income or expense, where material". Although the taxpayer, after he had begun his amortization of yearling cattle inventory values, was still employing an overall accrual method, we conclude that he was attempting a change in the handling of a material item. Cattle raising was his business and cattle breeding was an important and material part of that business. The 5th Circuit has characterized this kind of thing in *Carter*, *supra*, when it said, p. 601 of 257 F.2d:

> "It therefore amounts simply to an effort by petitioner, in his desire to use his cost rather than inventory as a basis, retroactively to change his method of accounting, which cannot be done."

Compare *Frost*, *supra*, p. 1120 of 28 T.C.

The taxpayer asserts that he is only correcting a compelled error which falls far short of qualifying as a change in his accounting system. He cites *Beacon Publishing Co.* v. *Commissioner of Internal Rev.*, 10 Cir., 218 F.2d 697, 702; *Wetherbee Electric Co.* v. *Jones*, W.D. Okla., 73 F. Supp. 765, appeal dismissed by stipulation, 10 Cir., 164 F.2d 278; and *O Liquidating Corp.*, T. C. Memo. 1960-29, Docket No. 69767, decided February 25, 1960, 1960 CCH T.C. Memo. Dec. 24,067(M), P-H T.C. Memo. Dec. Par. 60,029. We need not pass upon the question of the validity of error corrections without the Commissioner's consent. We need only reiterate, in response to the taxpayer's argument, that we agree with the 5th Circuit in *Carter* when it described their taxpayer's effort "to use

his cost rather than inventory as a basis" as an attempt "to change his method of accounting". Here, correspondingly, is an attempt to accomplish, although over six years, a zero basis rather than inventory as a basis. This too we regard as an attempted change in the method of accounting.

The taxpayer suggests and has endeavored to demonstrate that in any event a request for permission to change this accounting feature would have been denied by the Commissioner. There is nothing here, however, to convince us that a denial would have been arbitrary. The applicable standard is whether the accounting clearly reflects income, §§ 446(b), 471. The Commissioner's requirement that the taxpayer continue to follow his existing method was within his administrative discretion; that discretion is "wide" and it is not in the province of this court "to weigh and determine the relative merits of systems of accounting". *Brown* v. *Helvering, supra,* pp. 203-205 of 291 U.S.; *Automobile Club* v. *Commissioner,* 353 U.S. 180, 189-190.

Although one might usually assume that congressional intent, so far as relief to the farmer or rancher is concerned, is broad and liberal, we reach the conclusion here that the taxpayer cannot prevail on the issue before us. The judgment is therefore reversed and the case remanded to the district court for the entry of an appropriate judgment for the taxpayers on only the issue which was decided below in their favor and which is not questioned on this appeal.

A true copy.

Attest:

Clerk, U. S. Court of Appeals, Eighth Circuit.

(Judgment.)

United States Court of Appeals

FOR THE EIGHTH CIRCUIT.

No. 16539 - - - September Term, 1960.

United States of America, Appellant,

vs.

Harold M. Ekberg and Secrie Ekberg.

Appeal from the United States District Court for the District of South Dakota.

This cause came on to be heard on the record from the United States District Court for the District of South Dakota, and was argued by counsel.

On Consideration Whereof, it is now here ordered and adjudged by this Court, that the judgment of the said District Court, in this cause, be, and the same is hereby, reversed.

And it is further Ordered by this Court that this cause be, and it is hereby, remanded to the said District Court for the entry of an appropriate judgment for the taxpayers on only the issue which was decided below in their favor and which is not questioned on the appeal herein.

June 21, 1961.

APPENDIX B.

Statutes and Regulations Involved.

Internal Revenue Code of 1939:

SEC. 117. CAPITAL GAINS AND LOSSES.

* * *

(j) *Gains and Losses from Involuntary Conversion and from the Sale or Exchange of Certain Property Used in the Trade or Business.*—

(1) *Definition of Property used in the trade or business.*—For the purposes of this subsection, the term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (l), held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or (C) a copyright, a literary, musical, or artistic composition, or similar property, held by a taxpayer described in subsection (a) (1) (C). Such term also includes timber or coal with respect to which subsection (k) (1) or (2) is applicable and unharvested crops to which paragraph (3) is applicable. Such term also includes livestock, regardless of age, held by the taxpayer for draft, breeding, or dairy purposes, and held by him for 12 months or more from the date of acquisition. Such term does not include poultry.

(26 U.S.C., 1958 Ed., Sec. 117 (j).)

* * *

Internal Revenue Code of 1954:

SEC. 446. GENERAL RULE FOR METHODS OF ACCOUNTING.

* * *

(e) *Requirement Respecting Change of Accounting Method.*—Except as otherwise expressly provided in this chapter, a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary or his delegate.

(26 U.S.C., 1958 Ed., Sec. 446.)

* * *

SEC. 1232. PROPERTY USED IN THE TRADE OR BUSINESS AND INVOLUNTARY CONVERSIONS.

* * *

(b) *Definition of Property Used in the Trade or Business.—For purposes of this section—*

(1) *General Rule.*—The term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167, held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not—

(A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year,

(B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or

(C) a copyright, a literary, musical, or artistic composition or similar property, held by a taxpayer described in paragraph (3) of section 1221.

(3) *Livestock.*—Such term also includes livestock, regardless of age, held by the taxpayer for draft, breeding, or dairy purposes, and held by him for 12 months or more from the date of acquisition. Such term does not include poultry.

(26 U.S.C., 1958 Ed., Sec. 1231 (b).)

* * *

Treasury Regulations 111:

Section 39.22 (c)-6 *Inventories of livestock raisers and other farmers.*

* * *

A taxpayer who elects to use the "unit-livestock-price method" must apply it to all livestock raised, whether for sale or for breeding, draft, or dairy purposes. Once established, the unit prices and classifications selected by the taxpayer must be consistently applied in all subsequent years in the valuation of livestock inventories. No changes in the classification of animals or unit prices will be made without the approval of the Commissioner.

Treasury Regulations 118:

Section 39.22 (c)-6 *Inventories of livestock raisers and other farmers.*

* * *

(f) A taxpayer who elects to use the "unit-livestock-price method" must apply it to all livestock raised, whether for sale or for breeding, draft, or dairy purposes. Once established, the unit prices and classifications selected by the taxpayer must be consistently applied in all subsequent years in the valuation of livestock inventories. No changes

in the classification of animals or unit prices will be made without the approval of the Commissioner. Treasury Regulations Promulgated under the Internal Revenue Code of 1954:

Section 1.446-1. *General Rule for methods of accounting.*—

(a) *General rule.* (1) Section 446 (a) provides that taxable income shall be computed under the method of accounting on the basis of which a taxpayer regularly computes his income in keeping his books. The term "method of accounting" includes not only the over-all method of accounting of the taxpayer but also the accounting treatment of any item. Examples of such over-all methods are the cash receipts and disbursements method, an accrual method, combinations of such methods, and combinations of the foregoing with various methods provided for the accounting treatment of special items. These methods of accounting for special items include the accounting treatment prescribed for research and experimental expenditures, soil and water conservation expenditures, depreciation, net operating losses, etc. Except for deviations permitted or required by such special accounting treatment, taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books. For requirement respecting the adoption or change of accounting method, see section 446 (e) and paragraph (e) of this section.

* * *

(e) *Requirement respecting the adoption or change of accounting method.*

* * *

(2) (i) Except as otherwise expressly provided in chapter 1 of the Internal Revenue Code of 1954 and the

regulations thereunder, a taxpayer who changes the method of accounting employed in keeping his books shall before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. A change in the method of accounting includes a change in the over-all method of accounting for gross income or deductions, or a change in the treatment of a material item. Consent must be secured whether or not a taxpayer regards the method from which he desires to change to be proper. Thus, a taxpayer may not compute his taxable income under a method of accounting different from that previously used by him unless such consent is secured.

(ii) Examples of changes requiring consent are: A change from the cash receipts and disbursements method to an accrual method, or vice versa; a change involving the method or basis used in the valuation of inventories (see sections 471 and 472 and the regulations thereunder); a change from the cash or accrual method to a long-term contract method, or vice versa (see Sec. 1.451-3); a change involving the adoption, use, or discontinuance of any other specialized method of computing taxable income, such as the crop method; or a change in the treatment of any other items of income or expense, where material.

Section 1.471-6. *Inventories of livestock raisers and other farmers.*

* * *

(d) The "farm-price method" provides for the valuation of inventories at market price less direct cost of disposition. If this method of valuing inventories is used, it must be applied to the entire inventory except as to livestock inventoried, at the taxpayer's election, under the "unit-livestock-price method". If the use of the "farm-

price method" of valuing inventories for any taxable year involves a change in method of valuing inventories from that employed in prior years, permission for such change shall first be secured from the Commissioner as provided in Sec. 1.446-1 (e).

* * *

(f) A taxpayer who elects to use the "unit-livestock-price method" must apply it to all livestock raised, whether for sale or for draft, breeding, or dairy purposes. Once established, the unit prices and classifications selected by the taxpayer must be consistently applied in all subsequent taxable years in the valuation of livestock inventories. No changes in the classification of animals or unit prices will be made without the approval of the Commissioner.

(g) A livestock raiser who uses the "unit-livestock-price method" must include in his inventory at cost any livestock purchased, except that animals purchased for draft, breeding, or dairy purposes can, at the election of the livestock raiser, be included in inventory or be treated as capital assets subject to depreciation after maturity. If the animals purchased are not mature at the time of purchase, the cost should be increased at the end of each taxable year in accordance with the established unit prices, except that no increase is to be made in the taxable year of purchase if the animal is acquired during the last six months of that year. If the records maintained permit identification of a purchased animal, the cost of such animal will be eliminated from the closing inventory in the event of its sale or loss. Otherwise, the first-in, first-out method of valuing inventories must be applied.